

DEPARTMENT OF STATE REVENUE

**LETTER OF FINDINGS NUMBER: 01-0129
Adjusted Gross Income Tax – Payroll Factor
For Tax Years 1997 through 1999**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax—Payroll Factor

Authority: IC 6-3-2-2(d)
45 IAC 3.1-1-47

Taxpayer protests the auditor's determination that the wages earned by employees of two of taxpayer's subsidiary corporations and paid by taxpayer should be deducted from taxpayer's payroll factor denominator.

II. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is an operator of full service restaurants in Indiana and surrounding states. The company also sells frozen food items to grocery stores and institutional customers. In April of 1997, taxpayer transferred many of its Ohio restaurants to a separate corporation (hereinafter, the "Ohio Subsidiary"). In October of 1997, taxpayer transferred a number of its Michigan restaurants to a different separate corporation (hereinafter, the "Michigan Subsidiary"). Taxpayer controls both the Ohio and the Michigan Subsidiaries.

Taxpayer's corporate staff prepares payroll and withholding tax returns for taxpayer and the two subsidiaries. Pursuant to a management agreement, the subsidiaries pay a five percent (5%)

management fee to taxpayer for performing the services on their behalf. In addition thereto, the subsidiaries reimburse taxpayer for the costs taxpayer incurs in providing payroll compensation.

In fiscal years ending April 1998 and April 1999, taxpayer included in the denominator of its payroll factor, for adjusted gross income tax purposes, the total amount of compensation that it paid on behalf of the employees employed by the restaurants that were held by the Ohio and Michigan Subsidiaries. Pursuant to the audit performed for the years in question, the auditor determined that the payroll compensation paid on behalf of the employees of the Ohio and Michigan Subsidiaries should not be included in the denominator of taxpayer's payroll factor because taxpayer was reimbursed for the costs associated with providing the payroll compensation. Taxpayer protests the auditor's determination.

I. Adjusted Gross Income Tax—Payroll Factor

DISCUSSION

In determining its Indiana income, taxpayer included in the payroll factor for the apportionment of taxpayer's Indiana income subject to the adjusted gross income tax the payroll compensation paid by taxpayer to the employees of the Ohio and Michigan Subsidiaries. Pursuant to a management agreement, and in exchange for the payroll services provided by taxpayer, the subsidiaries reimbursed taxpayer for its costs (in addition to paying to taxpayer a five percent (5%) management fee). The auditor disallowed the inclusion of the payroll compensation paid on behalf of the employees of the Ohio and Michigan subsidiaries because taxpayer was reimbursed for those payroll expenses.

The payroll factor for apportionment of Indiana income is found at IC 6-3-2-2(d), which states in pertinent part:

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year. However, with respect to a foreign corporation, the denominator does not include compensation paid in a place that is outside the United States.

IC 6-3-2-2(d). This statute is clarified in 45 IAC 3.1-1-47 as follows:

The payroll factor shall include the total amount paid by the taxpayer for compensation during the tax period.

. . .

The term "compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded.

Only amounts paid directly to employees are included in the payroll factor. . . .

45 IAC 3.1-1-47.

The auditor's documentation reveals that on taxpayer's fiscal year 1999 pro forma Form 1120 federal tax return, taxpayer separated the management fee into two components, an income component and an expense component. Taxpayer listed in the column entitled "Other Income" an offsetting account entitled "Intercompany Employee Leasing". Taxpayer also included on the tax return as a payroll expense the amounts it paid in payroll compensation on behalf of the subsidiaries. The management agreements between taxpayer and the subsidiaries stated, *inter alia*, that the management fee owed by the subsidiaries for the payroll services shall equal 105% of the actual expenses incurred or accrued by taxpayer. From this information, the auditor determined that taxpayer was recouping directly the costs associated with the payroll compensation it provided for the subsidiaries. Consequently, because taxpayer received "reimbursements" from the subsidiaries that offset its payroll expenses on behalf of the subsidiaries, taxpayer, in actuality, did not incur as much payroll expense as taxpayer originally reported on its tax returns.

Taxpayer argues that although its payroll expenses and the management fee received therefor were separated into two components and listed on two separate lines of its pro forma tax return, it is only receiving from the subsidiaries one management fee. And, according to taxpayer, the entire amount that taxpayer expended on behalf of the subsidiaries in the form of payroll compensation should be included in the payroll factor as a legitimate payroll expense. However, taxpayer's argument does not negate the auditor's findings that the management fee received by taxpayer is in part a reimbursement of payroll expenses that reduces taxpayer's overall expense calculation.

Based upon the evidence before us, we find that the auditor did not err in determining that because taxpayer received a reimbursement, the payroll expenses attributable to the employees of the restaurants of the Ohio and Michigan Subsidiaries should be removed from the denominator of taxpayer's payroll factor.

FINDING

Taxpayer's protest is denied.

II. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. Taxpayer argues that it had reasonable cause for its failure to pay the appropriate amount of tax due because said underpayment of tax was based solely upon taxpayer's interpretation of relevant statutes and regulations. The Audit Division determined that a penalty should be assessed because taxpayer is a large corporation that has been audited by the Department several times, and in the instant case taxpayer was negligent in its Indiana income tax responsibilities.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed" 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

Taxpayer has failed to set forth a basis for establishing that it exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Given the totality of the circumstances, waiver of the penalty is inappropriate in this instance.

FINDING

Taxpayer's protest is denied.